IT 96-38
Tax Type: INCOME TAX
Issues: Unitary Apportionment
Net Operating Loss (Pre 1986)

STATE OF ILLINOIS
DEPARTMENT OF REVENUE
ADMINISTRATIVE HEARINGS DIVISION
CHICAGO, ILLINOIS

THE DEPARTMENT OF REVENUE OF THE STATE OF ILLINOIS, Petitioner	)	**No.**
v.	)	**FEIN:**
TAXPAYER (and Subsidiaries), Taxpayer	)	
) Linda K. Cliffel	)	**Administrative Law Judge**

RECOMMENDATION FOR DISPOSITION

APPEARANCES: Martin L. Eisenberg, for TAXPAYER A and Subsidiaries, and TAXPAYER B and Subsidiaries; Thomas P. Jacobsen, Special Assistant Attorney General, for the Illinois Department of Revenue.

SYNOPSIS:

This is a case involving TAXPAYER A (hereinafter "TAXPAYER A") and TAXPAYER B (hereinafter "TAXPAYER B"), both hereinafter referred to collectively as "Taxpayers." On October 3, 1991, TAXPAYER A filed Forms IL-1120-X for the tax years ended 12/31/1987 and 6/12/88. Also on October 3, 1991, TAXPAYER B filed Forms 1120-X for the tax years ended 12/31/88 and 12/31/89. The basis for the claims is the carryforward of pre-1986 federal net operating losses. The net operating losses which taxpayers seek to utilize were incurred by the members of the TAXPAYER B group prior to acquisition, and were computed and applied in a different manner in prior years. The differences in the computations and applications of the losses were due to changes in the filing method for the members of the unitary business groups in the 1976 to 1985 tax years. The claims were partially denied on November 22, 1991. Protests were filed on January 17, 1992 and January 28, 1992 and are considered to be timely filed.

By its protest and ensuing pre-trial determinations, the parties raise the following issues:

1) Is TAXPAYER B barred by the Statute of Limitations from recomputing the net operating losses to be carried forward due to reconfiguration of the unitary business group(s)?

2) If it is not barred by the Statute of Limitations, are there facts sufficient to redetermine the unitary business group(s)?

On consideration of these matters, it is recommended that the issues be resolved in favor of the Department.

FINDINGS OF FACT:

1. Prior to his death in 1978, FAMILY MEMBER A owned 100% of the stock of INDUSTRIES (hereinafter "INDUSTRIES"), NORTH (hereinafter "NORTH"), and PIONEER (hereinafter "Pioneer"). INDUSTRIES was the parent corporation of SERVICES, HOTELS, and CORPORATION. NORTH was the parent corporation of BANK, VIEW, which in turn was the parent of TRUST BANK, and NB, which was the parent of NB TRUST. (Taxpayer Brief, pp. 10-11; Department Brief, p. 8)

2. After the death of FAMILY MEMBER A, the FAMILY TRUSTS became the owners of the corporations (except for PIONEER) for the benefit of his six children. Each trust owned 16 2/3% of the parent corporations with the exception of Pioneer. Pioneer was 100% owned by the Estate of FAMILY MEMBER A until FAMILY MEMBER B acquired it on March 19, 1984. (Taxpayer Brief, p.10)

3. For the taxable years 1976-1978, INDUSTRIES and its affiliates filed nonunitary separate company returns. The affiliates included commercial, hospitality, service and banking corporations. The following affiliates generated separate company losses: NORTH, VIEW and NB (Taxpayer Ex. No. 13-15; Taxpayer Brief, p. 3)

4. For the taxable years 1979-1980, INDUSTRIES filed separate returns for its affiliates. Amended combined reports for 1979-1980 were filed for the following entities:

Financial Organizations	**Non-Financial Organizations**
VIEW	Business Equipment, Inc.
TRUST BANK	CORPORATION
NB	Corp.
NB TRUST	Inc.
BANK	HOTELS
Northwest Safe Deposit Co.	INDUSTRIES
NORTH	
PIONEER and Trust Co.	

For 1981, three separate combined returns were filed for the banking groups. (Taxpayer Brief, p.3)

5. On audit for the years 1979 to 1981, all of the companies listed above were combined on a unitary basis, including non-banking affiliates and banking companies. The non-banking companies' income was offset by the net operating losses of VIEW, NB, NORTH and Pioneer. (Dept. Ex. No. 7; Taxpayer Brief, pp. 3-4)

6. For the taxable years 1982-1984, the following combined reports were filed. (Taxpayer Ex. No. 19-21)

Financial Organizations	**Non-Financial Organizations**
VIEW	CORPORATION
TRUST BANK	Lane Air, Inc.
NB	SERVICES
NB TRUST	HOTELS
BANK	INDUSTRIES
Safe Deposit Co.	
NORTH	Travel Services
PIONEER	Corp.

On audit, the two separate unitary groups were allowed. (Dept. Ex. No. 8; Taxpayer Brief, pp. 4-5)

7. On October 1, 1985, NORTH changed its name to FINANCIAL, Inc. and the FAMILY TRUSTS transferred their complete interest in VIEW and NB to FINANCIAL in a transaction qualifying under Section 351 (a) of the Internal Revenue Code. On July 31, 1986, NB was merged into FINANCIAL pursuant to Section 332 of the Internal Revenue Code. (Taxpayer Ex. No. 2; Taxpayer Brief, p. 5)

8. On September 30, 1986, VIEW was merged into FINANCIAL pursuant to Section 332 of the Internal Revenue Code. For taxable years 1985 and 1986, FINANCIAL, VIEW and Pioneer filed combined reports on a unitary basis. (Taxpayer Ex. No. 3; Taxpayer Brief, p. 5)

9. Since 1985, FINANCIAL and its wholly-owned subsidiaries -- including VIEW, NB, Northwest -- filed as one unitary business group. Pioneer was included as a member of the unitary group. (Taxpayer Ex. No. 22-23; Taxpayer Brief, p. 5)

10. During the period 1974 until his death on September 18, 1978, FAMILY MEMBER A owned all of the stock of PIONEER and Trust. The Estate of FAMILY MEMBER A owned the stock until March 19, 1984, at which time it was acquired by FAMILY MEMBER B. FAMILY MEMBER B held the stock through December 31, 1986, the last year in question. (Taxpayer Ex. No. 3; Taxpayer Brief, p. 6)

11. The FAMILY family companies operated entirely within the State of Illinois during the years 1976 through 1985 with the exception of PIONEER. (Dept. Ex. No. 9)

12. On June 30, 1988, TAXPAYER B acquired all of the stock of FINANCIAL (formerly NORTH) in a transaction governed by Section 368(a)(1)(A) of the Internal Revenue Code. Also in 1988, FINANCIAL changed its name to TAXPAYER A (Taxpayer Brief, p. 6; Department Brief, p. 6; Taxpayer Ex. No. 11)

13. For 1987 and the tax year ended 6/30/88 TAXPAYER A filed a combined unitary return with the other former FAMILY banks. For the tax years ended 12/31/88 and 12/31/89, TAXPAYER A and its affiliates were joined in a combined return with TAXPAYER B. (Department Brief, p. 6)

14. On October 3, 1991, TAXPAYER A and TAXPAYER B filed refund claims as follows:

Taxpayer	Taxable Year Ending	Application of NOL	Claim
TAXPAYER A (formerly FAMILY Financial)	12/31/87	$7,367,813	$548,583
	6/12/88	$2,888,950	$257,459
TAXPAYER B/TAXPAYER A	12/31/88	$19,225,392	$1,314,886
	12/31/89	$20,289,179	$1,521,164
		$49,771,334	$3,642,092

(Taxpayer Brief, p. 6).

15. The net operating losses in question are attributable to losses incurred by VIEW and NORTH during 1976-1985. (Taxpayer Brief p. 6)

CONCLUSIONS OF LAW:

The issue here is whether TAXPAYER A and TAXPAYER B are barred by the statute of limitations from recomputing net operating losses (NOL's) to be carried forward by reconfiguring the unitary business group. *See*, IITA, sec. 207 (net operating losses shall be allowed as a carryover or carryback deduction in the manner allowed under Section 172 of the Internal Revenue Code)[1]; Rev. Rul. 56-285, 1956-1 C.B. 134; Rev. Rul. 81-88, 1981-1 C.B. 585; Rev. Rul. 81-87, 1981-1 C.B. 580; Phoenix Coal Company, Inc. v. Commissioner, 231 F.2d 420 (2d Cir., 1956); Springfield Street Railway Co. v. United States, 312 F.2d 754 (Ct. Cl. 1963) (taxable income in a closed year can be corrected in order to properly compute a net operating loss).

[1] Added by P.A. 84-1042, §1, eff. Nov. 26, 1985.

The threshold issue is whether taxpayers are correct in their assertion that the FAMILY companies were prohibited from using the unitary method of reporting for the years at issue. The taxpayers in this case (TAXPAYER B and TAXPAYER A) argue that the unitary method of reporting was prohibited by statute and that by correcting the reporting method, NOL's which were previously utilized would be freed up for use in later years.

TAXPAYER B and TAXPAYER A acquired FINANCIAL and its subsidiary banks in 1988. FINANCIAL (NORTH) and VIEW had generated losses in the years 1978-1985. In the audit of the 1978-1979 tax year, the Department found that all of the FAMILY companies (those companies which were owned by FAMILY MEMBER A prior to his death) were unitary and recalculated their respective tax liabilities on a combined basis. For 1979 and 1980 these companies had filed on a separate company basis, and in 1981 three distinct combined returns were filed for the banking groups. The companies agreed to the proposed change by the Department since the losses generated by certain members of the group offset income earned by other companies in the group. The net effect was a zero tax liability.

The Department notified the FAMILY companies regarding the tax year ended 12/31/82 that one-factor companies (the banks) could not be combined with three-factor companies. Therefore, for the years 1982-1984, the companies filed returns (IL-1120-X for 1982) which created two unitary groups: the financial group and the non-financial group. Again, the losses of FINANCIAL and VIEW were utilized to offset the income of other companies in the combination for no tax liability.

In 1988 TAXPAYER B acquired FINANCIAL, which subsequently changed its name to TAXPAYER A ("TAXPAYER A"). Taxpayers TAXPAYER B and TAXPAYER A now assert that the Department's determination of the unitary groups in the tax years ended 1979-1985 was erroneous, in that VIEW, NB, and NORTH could not have filed combined returns during this period because they did not have common ownership and the companies did business exclusively in Illinois.

IITA Section 1501(a)(27) provides that a unitary business group must be related through common ownership. "Common ownership" is the direct or indirect control of more than 50% of the outstanding voting stock of the persons carrying on the unitary business activity. According to Department regulation, "[f]or the purpose of IITA Section 1501(a)(27), an individual shall be considered to have indirect control over any stock that he is considered as owning under [Internal Revenue Code Section] 318(a)(1)."

Section 318(a)(1) attributes stock ownership to a specific group of related individuals:

> Members of family.
> (A) In general. An individual shall be considered as owning the stock owned, directly or indirectly, by or for
> (i) his spouse (other than a spouse who is legally separated from the individual under a decree of divorce or separate maintenance), and
> (ii) his children, grandchildren, and parents.

FAMILY MEMBER A's six children were beneficiaries of the FAMILY TRUSTS. Each trust had a 16 2/3% interest in VIEW, NB, NORTH and INDUSTRIES. Under IRC §318(a)(1) there is attribution only among natural persons. Accordingly, after the death of FAMILY MEMBER A in 1978, there was no common ownership between Pioneer, VIEW, NB, NORTH and INDUSTRIES.

In addition, former Illinois law prohibited affiliated companies that derived their business income exclusively from Illinois from forming a unitary business group.[2] The only company which had business activities outside of Illinois was PIONEER which was owned individually by FAMILY MEMBER B. Based on this criterion, the FAMILY companies were also not entitled to file a combined return.

It is clear from the above facts that combined returns were improper in the years at issue. That being the case, the next issue is whether TAXPAYER A and

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[2] IITA Section 1501(a)(27) formerly included the following language: "However, nothing in the preceding sentence will be construed as authorizing the formation of a unitary business group composed exclusively of members that derive business income solely from Illinois." P.A. 84-1400 deleted this provision effective 12/31/86.

TAXPAYER B may now recalculate the net operating loss carryforwards on a separate company basis and utilize those losses in 1987, 1988 and 1989.

Initially it is necessary to address the private letter ruling which the taxpayer received from the State of Illinois. The Department ruled that TAXPAYER A was entitled to carryover pre-1986 net operating losses from non-unitary years where a tax-free merger occurred. While taxpayer represented that these losses occurred in non-unitary years, taxpayer did not mention that unitary returns had been filed for these years, and that only now is that determination being questioned. Nor did taxpayer advise that the net operating losses were utilized in the unitary returns. (See Exhibit A of Taxpayer's Brief) Since the full facts were not presented in the request for a ruling, the Department is not bound by its determination.

Section 911 of the IITA sets forth the general statute of limitations for filing claims for refund:

> A claim for refund shall be filed not later than 3 years after the date the return was filed..., or one year after the date the tax was paid, whichever is later...

Taxpayers filed their claims for refund on October 3, 1991. While the refund claims are timely for the tax years ended 12/31/87 through 12/31/89, taxpayers seek to make adjustments to the years 1976 through 1985. These years are closed unless an exception to the statute of limitations applies. Federal law provides an exception to correct taxable income or loss in either the year the NOL is generated or the year it is carried to. Rev. Rul. 56-285, 1956-1 C.B. 134; Rev. Rul. 81-88, 1981-1 C.B. 585; Rev. Rul. 81-87, 1981-1 C.B. 580; Phoenix Coal Co., *supra*, Springfield Street Railway Co., *supra*. Since taxpayers seek to carry forward the NOL's to the open years 1987 through 1989 we must examine when NOL's may be recalculated in closed years.

In the cases cited by taxpayer, only items of income or deduction have been corrected in order to recalculate the NOL. See Commissioner v. Van Bergh, 209 F.2d 23, 54-1 USTC ¶9151 (2d Cir., 1954); Springfield Street Railway Co. v. United States, *supra*. The unitary method of reporting is unique to state

taxation, and therefore no cases relating to Section 172 of the Internal Revenue Code will be directly on point. What taxpayers are seeking to correct in their claim for refund is the method of combining the income of related taxpayers, not merely an item of income or expense.

The only case cited by the parties which bears any resemblance to the facts here is General Electric Co. v. Arizona Dept. of Revenue, Dkt No. 227-82-I, Arizona Board of Tax Appeals, 1983 Ariz. Tax LEXIS 22 (June 15, 1983). In General Electric, the taxpayer had filed Arizona income tax returns for 48 years using the separate accounting method. Under Arizona law, the taxpayer could choose one of two alternative methods of reporting with the permission of the Department of Revenue. On audit, the Department determined that an apportionment method of reporting would more clearly reflect income attributable to Arizona. The Department issued assessments for the years under audit (1973 through 1977) and disallowed net operating loss carryforwards from 1968 through 1970, by recalculating taxable income for the loss years under the apportionment method, determining that no net operating losses existed.

The State Board of Tax Appeals found that the Department was barred from recalculating the net operating loss carryforwards generated in closed years by using a different method of reporting even though those losses were being carried forward to years which were subject to audit. The Arizona Board followed General Electric in Walgreens v. Arizona Department of Revenue, Dkt. No. 484-86-I, Arizona Board of Tax Appeals, 1988 Ariz. Tax LEXIS 7 (Feb. 10, 1988), and held: "[r]ecalculation of a NOL based upon retroactive changes in reporting methods is improper." Further, the Board stated:

> In General Electric Company v. Arizona Department of Revenue [*supra*], this Board attempted to establish a bright-line rule against the retroactive imposition of accounting or reporting methods when the Department has performed a prior audit or received prior affirmative notice of said methods, and did not object when knowledge of such was obtained.

In an attempt to distinguish these cases, taxpayer cites Long[sic] v. Arizona Department of Revenue, Dkt. No. 695-89-1, Arizona Board of Tax Appeals,

Ariz. Tax LEXIS 16, (May 31, 1990) to support its proposition that the holding in General Electric cannot apply where the statute is unambiguous. Taxpayer argues that the holdings in General Electric, *supra*, and Lory, *id*, are different because the reporting method in General Electric was optional and the reporting method in Lory was mandatory (as is the statute prohibiting filing as a unitary group in the case at hand). Taxpayer's argument is not persuasive.

I am uncomfortable relying on any of these cases for the propositions for which they are cited. The issue in these two lines of cases is whether the government may impose a retroactive versus prospective change in a taxpayer's method of accounting where the taxing authority has acquiesced to the method in the past. Even though none of the cases cited are directly on point to the facts in the instant case, I find that General Electric and Walgreens are the more persuasive, and these decisions support the Department's position.

Taxpayers also contend that Erickson v. Commissioner, 61 T.C.M. (CCH) 2073 (1991), counters the Department's argument that fairness precludes taxpayers' claim to recompute NOL's in old years in order to receive a double deduction. In Erickson, the Court stated:

> [W]here prior to the expiration of the statute, the Commissioner knows or has reason to know of the erroneous deduction in that year, the Commissioner must disallow the deduction for the year in which it is claimed rather than attempt to recoup the tax in a subsequent year. 61 T.C.M. at 2077.

Taxpayer argues that since the Department had sufficient facts to make the determination that combined returns were not proper at the time of audit, it is estopped from arguing the statute of limitations now. The distinction between Erickson and the case here is that the Department is not seeking to go beyond the statute of limitations to assess additional tax, but rather the taxpayer is seeking to open the statute of limitations to claim additional refunds. The taxpayer was equally aware of the facts when it accepted the benefits of filing as a unitary group. The burden here is on the taxpayer who is claiming the refund, not the Department.

In addition, if the principle of quasi-estoppel applies in this case, it applies to the taxpayer. The Erickson Court, citing Southern Pacific Transportation Co. v. Commissioner, 75 T.C. 497, 838-839 (1980), states:

> The duty of consistency, which is sometimes referred to as "quasi-estoppel," is based on the theory that a taxpayer owes the Commissioner the duty to be consistent with his tax treatment of the same or related items and will not be permitted to benefit in a later year from an error or omission made in a prior year which cannot be corrected because the statute of limitations has expired.

In the instant matter, the Department of Revenue has issued refunds for years that are now closed to assessment. The Department has relied, to its detriment, on the actions of the taxpayers in the earlier years that its determination of the unitary business group was correct and accepted by taxpayers. The greater proportion of the net operating losses were generated by VIEW (which was a subsidiary of NORTH) and NORTH (now TAXPAYER A). NORTH agreed to the characterization of the companies as a unitary group and accepted the refunds which were generated thereby. The statute of limitations should not be used to protect a taxpayer from assessments in a closed year while taxpayer benefits in a later year. NORTH must be bound by its actions. It would be fundamentally unfair to allow taxpayers to reverse a position taken by another taxpayer and receive the benefit of the deduction, while the other taxpayer also received the benefit of the deduction but is no longer subject to assessment.

Another reason that taxpayers' arguments fail is that all members of a unitary group should join in filing claims for refund. In an Informational Bulletin issued by the Illinois Department of Revenue in 1991, the Department requires that

> If a member of a unitary group that filed separate Illinois returns wishes to make a change after the due date of the original filing, that member, as well as each Illinois filer in the group, **must** file an IL-1120-X. (emphasis added)

Because of the interrelationship between companies filing as a unitary group, requiring amended returns of each member of the group is entirely reasonable. Disregarding this requirement causes the very unacceptable result requested by

these taxpayers, that being that certain members of a unitary group (or nonunitary companies filing as unitary) take advantage of the exception to the statute of limitations for purposes of correcting net operating losses in order to receive a double deduction of the same NOL's while other members are shielded from the imposition of any deficiencies for the same period. Taxpayers should not be placed in a better position because they acquired FINANCIAL than FINANCIAL would have been in had there been no acquisition. If all members of the FAMILY group had filed amended returns, taxes would be due for the period 1976 through 1985. The fact that there was a change in ownership should not work to the disadvantage of the State.

It should also be noted that Illinois has a 15 year carryforward period.[3] If a taxpayer who is a member of a unitary group is entitled to change its method of reporting up to 15 years after the fact, and there is no recourse against former members of the group, the tax system would be chaos. The purpose behind a statute of limitations is to protect the taxpayer from stale claims and to promote diligence by the Department. Bolten v. Commissioner, 95 T.C. 397 (1990). The statute of limitations is not meant to be used by taxpayers to reap a windfall by allowing them to take a position which is diametrically opposed to one which was taken prior to the running of the statute.

Although I agree with the taxpayers that the Department erred in designating the various corporations under FAMILY family control as one or more unitary business groups, to allow TAXPAYER B and TAXPAYER A to utilize those NOL's now would unjustly enrich the taxpayers.

WHEREFORE, for the reasons stated above, it is my recommendation that the denial of taxpayers' claim be finalized.

Date:

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Linda K. Cliffel

[3] 35 **ILCS** 5/207.

Administrative Law Judge